Sound Income Strategies
Fixed Income Quarterly

Fixed Income Quarterly: Q3 2024

"A state of war only serves as an excuse for domestic tyranny."
-Aleksandr Solzhenitsyn

The Markets:

Investors were looking for any good news at the beginning of the quarter to justify a September rate cut by the Federal Reserve and a negative 10 bps print in the month-over-month change in the CPI, along with other lower-than-expected CPI prints, at the beginning of July, gave them something to cheer. The heavy bets on a handful of AI and technology stocks started to run out of steam, while small-cap value and even large-cap value names started to catch some of that fire that the Mag-7 held all year for an expected rotation out of tech/ growth names into struggling value equities.

While the markets welcomed slowing inflation numbers during July, investors felt the opposite during the beginning of August with lower-than-expected construction spending, ISM manufacturing numbers, and a jump up to 4.3% from 4.1% in the unemployment rate, which pushed markets to gap down at the beginning of August. Further pressuring equity markets was the fact that the BOJ increased their rates by ¼ point at the end of July leading to an unwind of the carry trade in early August.

By mid-August, a continuation of lower PPI and CPI numbers further confirmed that inflation was easing and pushed equities higher, and bond yields lower. However, after reaching some lows in early August many of the heavy tech names that had pulled the market head during the first half of 2024 started to come back, though they haven't reached their early July peaks.

Toward the end of August, the government revised their jobs number down by over 800,000 for the April through March period, in addition to the poor July jobs numbers released in August, suggesting that the labor market has not been as strong or as rosy as the current administration suggested, because the 800,000 downward revision was much more than a rounding error for the Labor Department. Entering mid-September the CPI year-over-year, (YoY) number continued to fall from 2.9% to 2.5%, boosting equities and pushing returns back into positive territory, leaving the Dow +8.7%, S&P500 at +5.9% and the NASDAQ up +2.75% for Q3. High-dividend equities lead the broader market for the first time in 2024. Year-to-date, the Dow is +13.8%, the S&P is +21.9%, and the NASDAQ is +21.8%.

For Internal Use Only

Bond World:

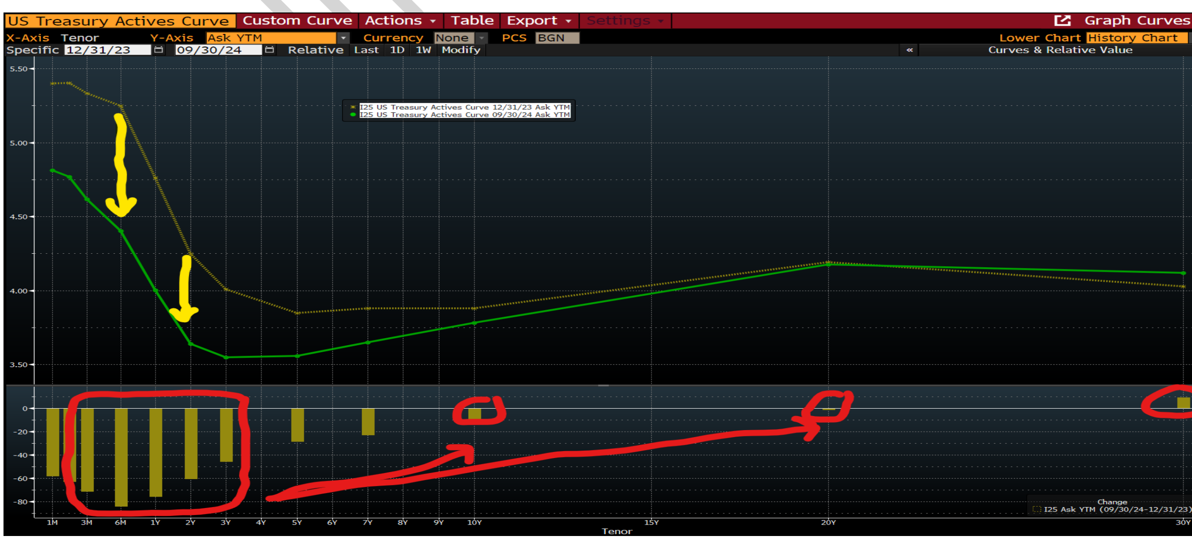
Inflationary pressures slowly continue to deflate with oil down over 18% during the quarter pushing gasoline supplies up versus demand. This, combined with a weakened labor market, moved the Fed to pivot its policy to start cutting rates at their September 18 meeting. The Fed cut by one-half percent from a 5%-5.5% collar down to a 4.5%-5.0% level with more cuts expected before the end of the year.

This move, along with the market expectations of future moves has finally pushed short-term rates down faster than longer-term rates, (remember Bull Steepener) leading to a normal positively slopped yield curve. Though T-bills, 1-month through 1-year will need further rate cuts to fall below the 10-year US Treasury.

Q3 Yield Curve movement:

Source: Bloomberg

YTD Yield Curve movement:



Source: Bloomberg

For Internal Use Only

Most IG corporate bond yields continued to tighten, except for Autos, Energy, and Travel, while HY corporate bond yields actually widened by 7 bps for BB credits and 17 for single B credits. However, just about every sector in IG has compressed during 2024 in addition to the tightening of the Treasury curve.

US Investment Grade Credit Performance

Sep 27, 2024					Change in OAS			Change in YTW			Excess Returns			Total Returns		
	OAS	YTW	Duration	Price	WoW	QTD	YTD	WoW	QTD	YTD	WoW	QTD	YTD	WoW	QTD	YTD
Investment Grade	**92 bp**	**4.69%**	**6.8 yrs**	**$96.29**	**-1 bp**	**-4 bp**	**-12 bp**	**-0 bp**	**-82 bp**	**-46 bp**	**0.07%**	**0.52%**	**1.75%**	**0.04%**	**5.96%**	**5.98%**
Ratings																
Sector																
Financials	**91 bp**	**4.61%**	**5.1 yrs**	**$98.43**	**-2 bp**	**-7 bp**	**-23 bp**	**-1 bp**	**-94 bp**	**-67 bp**	**0.10%**	**0.64%**	**2.35%**	**0.12%**	**5.43%**	**6.79%**
Banking	88 bp	4.55%	4.6 yrs	$99.09	-2 bp	-7 bp	-25 bp	-1 bp	-98 bp	-73 bp	0.10%	0.67%	2.41%	0.13%	5.28%	6.91%
Financial Services	91 bp	4.60%	5.1 yrs	$98.04	-2 bp	-4 bp	-20 bp	-1 bp	-92 bp	-63 bp	0.09%	0.58%	2.15%	0.11%	5.38%	6.58%
Insurance	104 bp	4.82%	7.0 yrs	$96.71	-2 bp	-5 bp	-23 bp	-1 bp	-80 bp	-55 bp	0.13%	0.65%	2.59%	0.10%	6.17%	6.68%
Industrials	**91 bp**	**4.70%**	**7.5 yrs**	**$95.28**	**-1 bp**	**-2 bp**	**-6 bp**	**+0 bp**	**-76 bp**	**-36 bp**	**0.03%**	**0.36%**	**1.32%**	**-0.01%**	**6.06%**	**5.47%**
Automotive	100 bp	4.63%	3.9 yrs	$99.38	+2 bp	+8 bp	-1 bp	+2 bp	-87 bp	-54 bp	-0.12%	-0.20%	1.06%	-0.07%	4.08%	5.56%
Basic Industry	108 bp	4.86%	7.1 yrs	$97.39	-3 bp	-2 bp	-21 bp	-2 bp	-76 bp	-50 bp	0.22%	0.39%	2.04%	0.18%	6.03%	6.31%
Capital Goods	84 bp	4.60%	6.8 yrs	$96.90	-1 bp	-5 bp	+3 bp	-0 bp	-83 bp	-30 bp	0.07%	0.66%	0.65%	0.04%	6.12%	4.93%
Consumer Goods	76 bp	4.54%	7.4 yrs	$96.56	-1 bp	-5 bp	-9 bp	-0 bp	-81 bp	-38 bp	0.03%	0.60%	1.44%	-0.01%	6.29%	5.63%
Energy	109 bp	4.91%	7.6 yrs	$97.06	+1 bp	+4 bp	-6 bp	+2 bp	-69 bp	-35 bp	-0.10%	-0.02%	1.70%	-0.15%	5.77%	6.00%
Healthcare	81 bp	4.64%	8.5 yrs	$95.13	-1 bp	-4 bp	-3 bp	+0 bp	-74 bp	-29 bp	0.03%	0.50%	1.19%	-0.05%	6.56%	5.21%
Leisure	108 bp	4.70%	4.1 yrs	$98.57	-4 bp	+8 bp	-8 bp	-4 bp	-86 bp	-55 bp	0.18%	0.16%	1.53%	0.22%	4.55%	6.20%
Media	125 bp	5.09%	8.7 yrs	$90.78	-0 bp	-1 bp	+2 bp	+1 bp	-71 bp	-22 bp	-0.07%	0.11%	0.70%	-0.15%	6.13%	4.58%
Real Estate	101 bp	4.69%	5.5 yrs	$94.88	-1 bp	-8 bp	-28 bp	-1 bp	-90 bp	-63 bp	0.11%	0.72%	2.46%	0.12%	5.79%	6.86%
Retail	70 bp	4.50%	7.8 yrs	$94.05	-1 bp	-4 bp	-3 bp	-0 bp	-78 bp	-31 bp	0.11%	0.67%	0.92%	0.05%	6.43%	4.98%
Services	78 bp	4.62%	8.0 yrs	$93.48	-1 bp	-4 bp	-11 bp	+0 bp	-73 bp	-36 bp	0.01%	0.26%	1.74%	-0.05%	6.24%	5.67%
Technology & Electronics	74 bp	4.53%	7.6 yrs	$93.63	-1 bp	-1 bp	-1 bp	-0 bp	-76 bp	-31 bp	0.03%	0.20%	0.83%	-0.02%	5.90%	4.86%
Telecommunications	95 bp	4.77%	8.5 yrs	$92.79	-2 bp	-2 bp	-6 bp	-1 bp	-71 bp	-30 bp	0.15%	0.39%	1.65%	0.08%	6.44%	5.57%
Transportation	94 bp	4.82%	9.1 yrs	$93.59	-1 bp	-3 bp	-5 bp	-0 bp	-72 bp	-29 bp	0.14%	0.52%	1.30%	0.05%	6.69%	5.16%
Utilities	**99 bp**	**4.83%**	**8.3 yrs**	**$95.67**	**-1 bp**	**-7 bp**	**-14 bp**	**-0 bp**	**-78 bp**	**-39 bp**	**0.14%**	**1.06%**	**2.40%**	**0.08%**	**7.07%**	**6.45%**

Source: CreditSights, ICE Data Indices, LLC

	OAS	YTW	Duration	Price	OAS WoW	OAS QTD	OAS YTD	YTW WoW	YTW QTD	YTW YTD	Excess WoW	Excess QTD	Excess YTD	Total WoW	Total QTD	Total YTD
High Yield	**314 bp**	**7.00%**	**3.0 yrs**	**$96.55**	**-1 bp**	**-4 bp**	**-20 bp**	**-2 bp**	**-85 bp**	**-65 bp**	**0.05%**	**1.36%**	**3.57%**	**0.12%**	**5.30%**	**8.05%**
Ratings																
BB	191 bp	5.79%	3.2 yrs	$98.80	0 bp	+7 bp	-13 bp	-0 bp	-74 bp	-54 bp	-0.02%	0.21%	2.41%	0.04%	4.31%	6.86%
B	307 bp	6.98%	2.7 yrs	$98.45	0 bp	+17 bp	-35 bp	-2 bp	-65 bp	-79 bp	0.02%	0.83%	2.82%	0.08%	4.58%	7.26%
CCC	840 bp	12.06%	2.8 yrs	$84.31	-10 bp	-102 bp	-11 bp	-11 bp	-186 bp	-73 bp	0.46%	7.83%	10.88%	0.53%	11.61%	15.50%

Source: CS, Bloomberg, Bank of America – Merrill Lynch

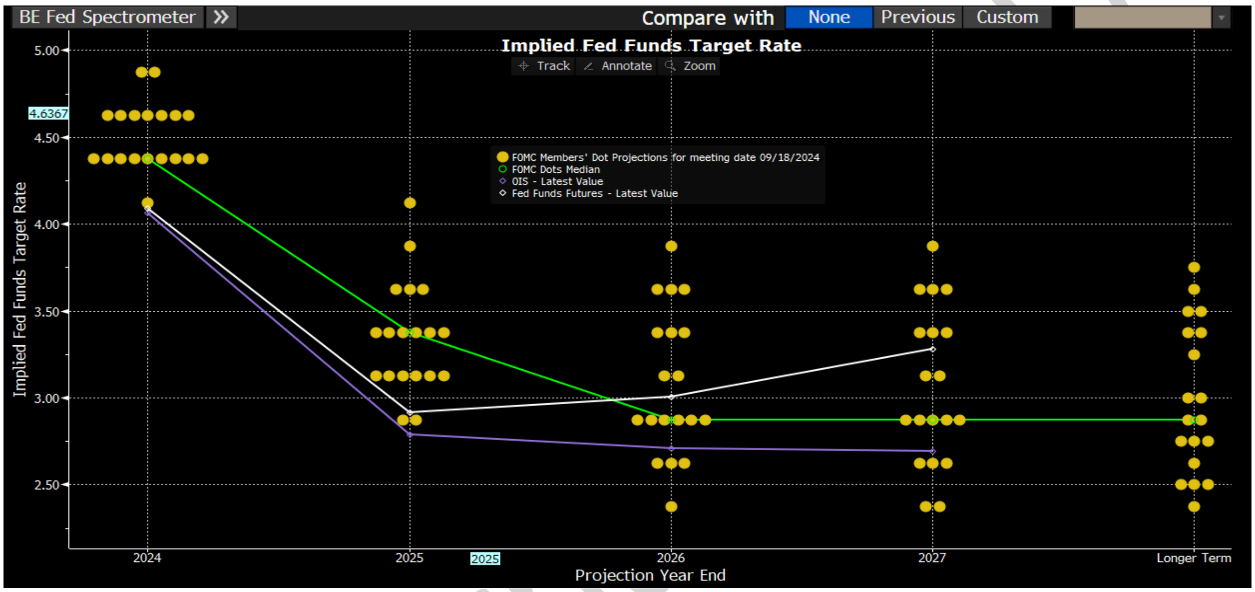
Source: CS, Bloomberg, Bank of America – Merrill Lynch

The 10-year US Treasury yield fell from 4.48% at the beginning of the quarter to close at 3.75%, a 6.4% increase. Our Core Plus portfolio returned roughly +5.4% during the quarter bringing the annual return to just over +9% YTD, while the Bloomberg aggregate returned +5.2% for the quarter bringing its total to 4.44% YTD.

For Internal Use Only

Outlook:

Given the Fed's "Dot Plot", shown below, they are suggesting that rates could fall another 50-75 bps before the end of this year, but as we approach the next 4 years there is great dispersion among the voting members of the Federal Reserve. Their uncertainty will carry over into the financial markets leading to more volatility, similar to this past Q3, given markets don't like uncertainty. That said, I still believe the economic slowdown will continue until we reach a recession regardless of how it is labeled by the media.



Source: Bloomberg

I've been asked by more than one advisor this quarter about yields coming down in our portfolios and I can tell you that it's not because of bond losses or companies cutting dividends, but because we've had so much appreciation in many names this year. Given the expected cut in rates during the quarter, our REITs have probably had the best quarter on our record, granted I believe the run-up has been a little overdone. However, each of our asset classes has had an excellent leg up in value given the markets expectations in rate cuts. I want to point out that we are long-term investors and while it might be difficult to fully invest new clients into our income-based securities, we have to remember that we are taking a long-term approach. It might take 3 to 5 years before we can assess the progress in our style. Just think of new clients who came on board in 2022. It was the worst fixed-income market in over 40 years, but we came back in full last year. We won't be able to always time perfectly, (and we at HQs aren't allowed anyway), but with quality companies in our line-up we should perform well over time and that is what we strive to do.

The Fed is more worried about the labor market than inflation at this point, hence the pivot, and do I believe that we could see a material dip late in the coming quarter, which could be a buying opportunity for many, obviously these need to be evaluated versus a continued climb in valuation. Given the volatility this past quarter and rate-cutting expectations, I didn't make any new adjustments to the portfolios during Q3. There are three or four swaps I am considering for Q4, but I am pleased with how most of our companies have been performing so far.

Another concerning factor is the increasing escalation in the Middle East which could also add volatility to the markets next quarter in addition to a slowing economic outlook and unknown interest rate expectations. However, we do know rates still have further to fall and it looks like equity markets have started to rotate over to more defensive value/dividend equities versus the mighty growth/tech names. Therefore, I do expect another positive quarter for our portfolios, though not nearly as high as Q3 has been for us.

Sincerely,
Eric Lutton, CFA®
Chief Investment Officer

Sound Income Strategies